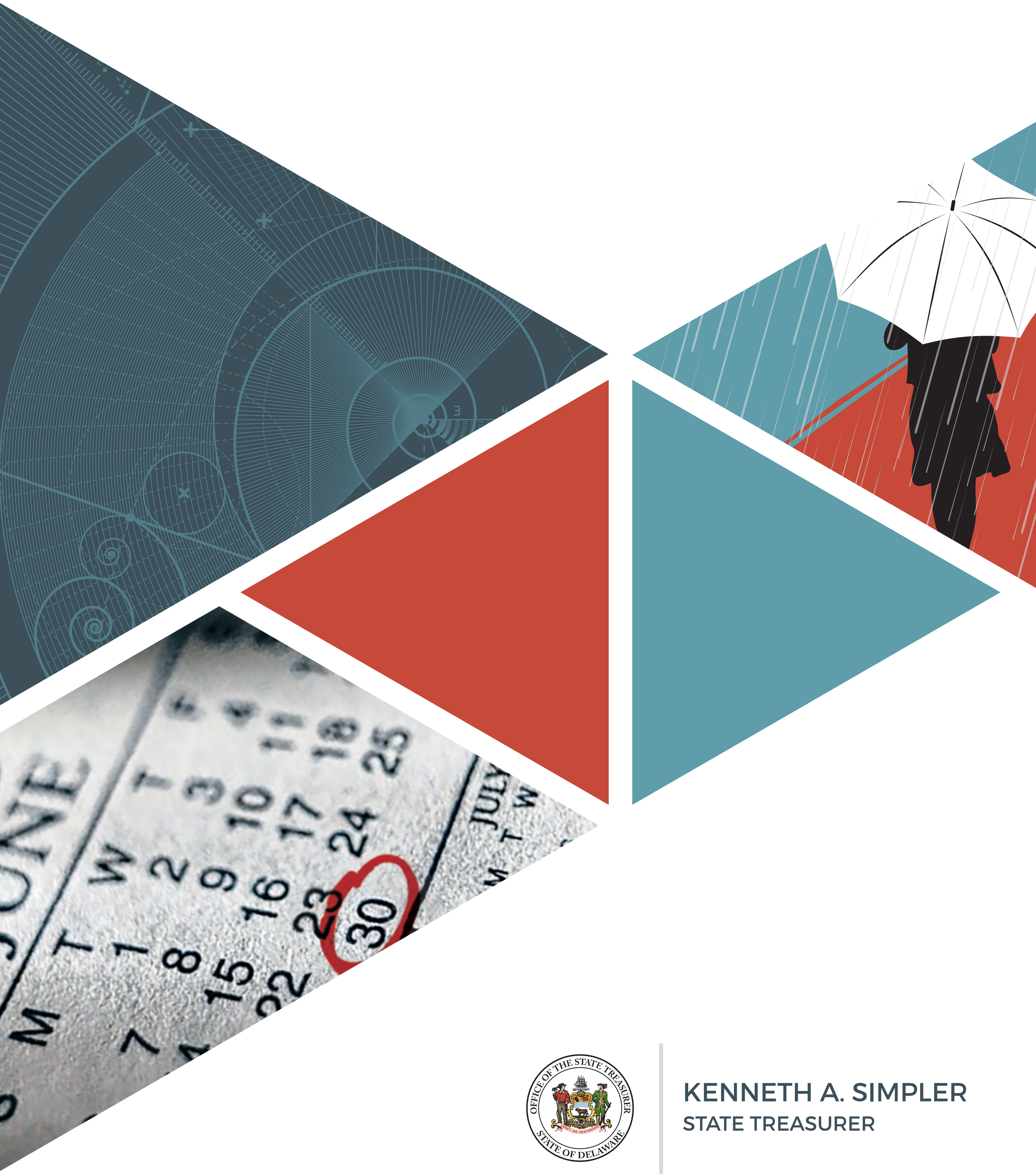
NEWSLETTER | Q1 2018

BLUEPRINT FOR A BARGAIN:
Let's Listen and Act



KENNETH A. SIMPLER

STATE TREASURER

DELAWAREANS, WE ARE HAVING AN "E.F. HUTTON MOMENT." LET'S LISTEN.

For context, E.F. Hutton was a dominant financial advisory business for several decades during the last century. The firm was swallowed up in a wave of bank mergers in the 1980s, but only after running a series of attention-grabbing television commercials on par with today's GEICO ads.

Instead of comical send-ups ending with a reminder that "15 minutes could save you 15% or more on your car insurance," the Hutton spots had an ordinary Jane or Joe refer to "E.F. Hutton" in casual conversation. The mere mention of the Hutton name triggered a sea of otherwise preoccupied people to stop whatever they were doing to lean in and listen. The tagline was: "When E.F. Hutton talks, people listen."

The public may no longer be straining to take in Hutton's fiscal wisdom, but I urge Delawareans to lend an ear to absorb what those in our State's high offices are saying about our collective finances. They are talking, and we should listen.

During the last legislative session, the General Assembly passed a joint resolution (HJR 8) to create an advisory panel under the Delaware Economic and Financial Advisory Council (DEFAC) that would undertake a sweeping study of our budgeting processes and make recommendations as to if and how we can improve on a framework that dates back to the late 1970s. The General Assembly spoke in unison in adopting HJR 8, and we should listen.

Members of the newly formed DEFAC panel (the Panel) asked the State's top four financial officers — the Governor's Secretary of Finance and the Director of the Office of Management and Budget, the Legislature's Controller General, and the State Treasurer — to work together to present information and make proposals for the Panel's consideration. Those financial officers began with differing concerns and alternative solutions, but ultimately came together to offer consensus proposals to the Panel. Again, we should listen.

This month, the full Panel — a group consisting of legislators, chairs of DEFAC and its subcommittees, appointees of the Governor drawn from the public and private sectors and the aforementioned financial officers — released the report envisioned by HJR 8 (the Report), reflecting a bold set of recommendations to enact new spending controls, create a budget stabilization fund and revamp our revenue portfolio. The Panel voted unanimously on the need for and means to achieve historic budget reforms. Truly, we should listen.

And, when we are done listening, we should act.

THE STAKES ARE HIGH AND AFFECT ALL OF US

For too long, we have allowed our State's finances to be run using budgeting systems that were put in place before half of us were even born. The then radical financial reforms undertaken in the late 1970s — when Delaware was in a sorry fiscal condition and declared "bankrupt" by then Governor Pete du Pont — put our State in the vanguard of good governance and ushered in a generation of prosperity.

The bloom, however, is off that rose. Forty-year old fiscal practices and policies are failing to meet the needs of our citizens in a manner that is certain, sustainable and sufficient. Take the current and next fiscal years as cases in point.

Less than one year ago, our State government was absorbed in finding solutions to dig our way out of a 10% budget deficit. The debates in the General Assembly as to how to cut and spend our way out of that hole were both paralyzing and polarizing.

Flash forward eleven months and we are looking at budget growth of more than 10%! The crisis this year is how to restrain the spending gusher in a free for all reminiscent of a typical Black Friday.

If real people, small businesses and critical service providers were not affected by this seeming absurdity, the scramble this year to undo parts of what was done last year might appear comical. The reality is no farce.

Last year's spending cuts were not mapped out in advance as part of a long-range strategic plan. They were contrivances to "balance the budget," determined over a matter of weeks by well-meaning legislators acting on a fraction of the information that they should have to make such decisions. Much of those cuts could now be reversed as the requisite revenues have reemerged.

Similarly, some of the tax increases that were professed to be so badly needed to "balance the budget" during the last legislative session likely will be revisited. In the fallout, revenue forecasters are suspected of sandbagging income figures to achieve politically motivated outcomes. In reality, the tax system that we have put in place over decades and failed to manicure in a rational fashion has led to a revenue portfolio that is both lagging in growth even as it is increasing in volatility, a combination that makes predicting our future tax income ever more challenging and less reliable.

Have we allowed process to triumph over progress? Some, especially veterans of our Legislature, claim in defense of the status quo that adhering to our well-worn practices has allowed us to balance the budget every year for the last four decades. But is this the height of good finance, or to borrow a term from our budget process, just a "door opener" — a necessary but far from sufficient duty?

We can and should do much more than just "balance the budget" from year-to-year. The recommendations of the Panel tell us both what and how. Taken together, the three-part package of reforms builds on our current, myopic focus on annual solvency by instituting mechanisms that will foster year-over-year certainty and ensure long-term sustainability.

Moreover, the reforms will orient us away from the task of simply allocating the fiscal purse and place greater scrutiny on how our investments are paying off.

Three years of serving as your State Treasurer has convinced me that we need to refocus our entire State financing system around the concept of value: not how much we tax or how much we spend, but what we get for what we pay.

Value is not just the key to fiscal prosperity, it is the consensus issue that tamps down political discord and dysfunction.

Conservatives, Progressives, Democrats, Republicans, Independents and everyone in between wants to see our government officials and agencies engaged in providing and procuring goods and services that are commensurate in quality and quantity with the taxpayer monies we spend and invest.

Our current budgeting system does not rally us around that goal. It is time to institute reforms that do. And we need to act quickly.

"Neither party has a monopoly on applying common sense to these issues. Both parties must agree that a more permanent solution involves addressing both spending and broadening reliable revenue sources. And doing so requires some faith and trust in the other side, something the political process here and elsewhere struggles with these days."

— Mike Houghton, Advisory Panel Chair
The News Journal
May 16, 2018

“We do not face a budget deficit this year but, as a state, we cannot lose sight of our long-term financial challenges... This is a long-term challenge that will require a long-term commitment. We should finally commit to addressing our budget problems so we can get back to making investments that matter — in our schools, our communities and our economy.”

— Governor John Carney
Official Statement
May 15, 2018

"The problem is structural, which means you see it less in good times than in bad. This proposal is not about managing year-to-year solvency. It's about eliminating these peaks and valleys in a way that maintains a level of growth we can sustain long term."

— State Treasurer Ken Simpler
The News Journal
May 16, 2018

“If we had this (Budget Stabilization Fund) in place, if it was fully funded, 90 percent of all economic situations that we’ve ever encountered we would be able to handle with this fund and not have to make significant, drastic decisions.”

— State Rep. Quinn Johnson
Delaware Public Media
May 15, 2018

TIME IS OF THE ESSENCE – YOU CAN MAKE A DIFFERENCE

The window to effect these reforms is closing rapidly as our fiscal year ends on June 30th. Critical components of the budget recommendations advocated by the Panel require the Legislature to vote on amendments to our Constitution. Under Delaware law, such legislation must be approved by super-majorities of two consecutive General Assemblies.

The current General Assembly is in its second year and will be dissolved after the end of this fiscal year, ushering in a new General Assembly for another two years. If the reforms are not voted on in this session, there is little likelihood they will be taken up in the first year of the next General Assembly, as they could not be voted on again for another two years. The time to act is now.

Even legislators with some misgivings as to portions of the recommendations should be willing to take up the initial leg of the required amendments as such a vote is required but not adequate to amend the Constitution.

As a matter of law, the first vote of this General Assembly has no force or effect by itself and does not bind the next General Assembly to take the second vote. In effect, the first vote to amend the Constitution simply makes the second leg possible, preserving a valuable option to study details of the recommendations further and/or provide legislators with more time to resolve competing ideas as to how to handle some aspects of the accompanying statutory proposals. (Note that only a portion of the Panel's recommendations requires constitutional changes; Other parts of the proposals can be implemented via statute).

The following pages of this newsletter set out the recommendations of the Panel as well as portions of the preamble to the Report. The Report and the entirety of the materials presented to the Panel, including the minutes reflecting the discussions that transpired during those meetings, can be found on the Department of Finance's website at: finance.delaware.gov/publications/BudgetSmooth/res8.shtml.

Critically, the legislation to enact the Panel's recommendations will be submitted to the General Assembly when the members reconvene the week of June 4th for the final push to fiscal year end. In just those four weeks, the fate of the reforms will be determined.

Our elected officials in the Legislature will either step up and provide for our ability to reinvent the way we do business in state government, or they will falter and consign us to the status quo. The former path holds the promise towards progress, the latter a commitment to a tired process that puts form over substance.

> If after considering these reforms, you concur with their intent and effect, I urge you to pick up the phone, pen a letter, send an email or otherwise contact your Representative and Senator and let them know that you want to see these changes made to our budgeting processes.

We are tired of seeing the can kicked; we want the system fixed.

Do not underestimate the power of your voice, individually, much less collectively. Reforms of this scale present themselves for consideration infrequently – judging by Delaware's history perhaps only once every half century or so.

If you've listened and heard the blueprint for this bargain, let's act now to see it implemented. The next generation is counting on you.

SELECTED SECTIONS OF THE PREAMBLE TO THE REPORT

The 149th General Assembly approved House Joint Resolution 8 (Resolution). The Resolution created an advisory panel (Panel) under DEFAC to study fiscal controls and budget smoothing mechanisms that could be added to Delaware's current financial framework to better address the State's systemic fiscal difficulties and long-term budget challenges.

The Panel was tasked with drafting a report to be presented to the Governor and the General Assembly that specifically addressed:

a. the State's historic adherence to the 98% appropriation limit and its use of the Budget Reserve Account;

b. the need for reasonable restrictions on the use of budget surpluses, including but not limited to those arising from unforeseen revenue growth or one-time revenues, to control the expansion of expenditures over the long term;

c. and, the benefits of a budget stabilization fund to store excess funds during periods of budget surplus and cover operating deficits during periods of budget deficit. [1]

The Panel strongly encourages the Governor and legislators to consider implementation of these recommendations as a "package" for reasons of both political viability and overall efficacy.

While each reform can be attempted alone, the Panel considers the politics of such an approach more challenging than their adoption in totality.

The Panel also believes that the reforms taken as a whole are greater than the sum of their parts, with each proposal reinforcing and working in harmony with the others.

Finally, it is the Panel's position that implementation of changes to the fiscal controls and budget stabilization mechanisms should be enacted via a combination of constitutional amendment and statutory codification. The historic fiscal reforms of the late 1970s were implemented in this fashion and resulted in decades of adherence to both their spirit and letter.

Delaware's opportunity to build on its legacy of fiscal responsibility will be best served by constitutionally and statutorily cementing new reforms in the same manner as its existing budgetary framework.

RECOMMENDATION NO. 1

REDEFINE THE APPROPRIATION METHOD AND BUILD ON CURRENT FISCAL CONTROLS

The current method of setting the budget appropriation is based on a forecast of future revenues and excess cash and is limited to 98% of such sum.

The Panel recommends amending the current method of setting the annual appropriation limit by including a constraint that would restrain growth in appropriations to the operating budget and grant-in-aid funding to the same rate of growth as an economic metric — the "budget benchmark" while also allowing for a minimum level of authorization to the capital budget bill which may not or should not be funded through General Obligation Bonds.[2]

The new constraint would treat amounts above the benchmark as "extraordinary," and would provide for the appropriation of half of such funds only as one-time monies available to meet non-recurring expenditures with the other half being used to fund its budget stabilization fund (see below).

Once fully funded, extraordinary funds otherwise required to be appropriated to the stabilization fund would be available for appropriation for any purpose.

The Panel further recommends that the benchmark initially be constructed from an index comprised of equal weightings of the 3-year average of: (i) Delaware personal income growth and (ii) Delaware population growth and inflation reflecting the pool of goods and services purchased by government (as represented by the "Implicit Price Deflator for State & Local Government Purchases").

> Effectively, the benchmark is designed to approximate a long-run level of sustainable resources and expenditures and provide policymakers with guidance as to the need to make ongoing adjustments to the State's revenue and expenditure portfolios.

The Panel recommends that DEFAC be tasked with calculating the benchmark annually and reviewing and making any recommendations to the Governor and General Assembly regarding the construction of the benchmark periodically, but no less frequently than every five (5) years.

1 Delaware General Assembly, HJR 8, Creating an Advisory Panel to the Delaware Economic and Financial Advisory Council to Study Potential Fiscal Controls and Budget Smoothing Mechanisms, 149th General Assembly, Introduced June 30, 2017. Passed by House and Senate. Signed by Governor August 25, 2017.

RECOMMENDATION NO. 2

REPURPOSE THE BUDGET RESERVE ACCOUNT INTO A BUDGET STABILIZATION FUND

Delaware's current Budget Reserve Account (BRA) has never been utilized.

> The Panel recommends reforming the constitutionally-mandated fund by increasing its size, providing for specific deposit and withdrawal rules, and converting the "rainy day fund" from an inactive savings mechanism into a means for policymakers to smooth cyclical volatility and cushion the impact of significant budget shortfalls.

The new Budget Stabilization Fund (BSF) would be seeded with the monies currently held in the BRA with a goal of growing the new reserve account to 10% of gross General Fund Revenues (twice the size of the current BRA).

Withdrawals from the BSF would be allowed if an operating deficit exceeds the 2% set-aside from the 98% rule or when growth in the 98% appropriations limit falls short of the growth in the budget benchmark. Withdrawals would be limited to the lesser of half of the shortfall or half of the BSF.

Finally, the BSF would have a "floor" of 3% (compared to the current 5% BRA) with withdrawals resulting in a balance below that level subject to the same constitutionally-mandated three-fifths supermajority vote of both houses of the General Assembly that is now required for withdrawals from the BRA.

At this level of funding, the BSF would provide Delaware with sufficient liquidity to weather most historical downturns with minimal or no expenditure cuts and/or revenue enhancements. Even in the most extreme cases, expenditure cuts and/or revenue enhancements would be more moderate than required under current budget rules.

As a consequence, the BSF not only serves to alleviate the toughest of budget decisions, but also provides counter-cyclical fiscal policy that should mitigate the severity and/or length of economic contractions.

RECOMMENDATION NO. 3

REFORM THE PERSONAL INCOME TAX TO BROADEN THE TAX BASE

The Panel supports the reforms to Delaware's personal income tax (PIT) set out in the earlier Council's May 2015 Report that were designed to improve the portfolio's responsiveness to economic growth without increasing revenue volatility or reducing competitiveness.

While certain of the Council's recommendations with respect to the corporate franchise tax, corporate income tax and estate tax have been adopted, other recommendations, most notably with respect to Delaware's single largest source of revenue, the PIT have yet to be addressed.[3]

The Panel "seconds" the Council's recommendations to broaden the base of the PIT via the elimination of itemized deductions, the consolidation of certain age-based tax preferences, and the introduction of a relatively high "means-test" for age-based tax preferences.

Additional revenues from these reforms would be used dollar-for-dollar in the first year of implementation to lower marginal tax rates including meaningfully reducing Delaware's highest marginal tax rate (currently 6.6% for taxable income above $60,000). In subsequent years, PIT growth would be both greater and more certain, better tracking Delaware's economy and generating significant additional revenues over current DEFAC forecasts (as demonstrated under sample scenarios set out in the full report).

> These reforms build upon recent federal tax reforms that lowered marginal tax rates and eliminated, reduced, or phased-out certain tax preferences in order to simplify and improve fairness in the tax code.

While additional PIT revenues would constitute amounts removed from private sector allocation decisions, the Panel believes that lower marginal rates and improved counter-cyclical public sector fiscal policy allow for this portion of revenue portfolio growth without harming, and potentially enhancing, Delaware's economic competitiveness when made in conjunction with the Panel's other recommended reforms.

2 Over the course of the last decade, roughly $40 million on average has been authorized annually in the capital budget bill for recurring expenditures that are not appropriately funded through General Obligation Bonds. To ensure such amounts are not bonded and that sufficient resources exist to meet such ongoing needs, the Panel recommends that the benchmark be applied to a base that is composed of operating funds, grant-in-aid monies, and a minimum amount of cash to the capital budget that is either fixed based on its historical average or limited to an amount not to exceed 1% of the operating budget.

3 The Panel also recognizes that changes were made to escheat, the third largest source of revenues for Delaware, but these were outside of the mandate of the previous Council and therefore not a part of the report. Similarly, the Panel recognizes that the 2015 Report recommended a change to provide for equal quarterly payments of corporate income taxes that has not been adopted and could be part of a package contributing to revenue neutrality or pursued separately.

Read Ken's newsletters online or sign up to receive them via email at treasurer.delaware.gov.

Blueprint for a Bargain: Let's Listen and Act

Bipartisan Budget Accord: Framing a Grand Bargain

Creating a Performance-Driven Culture: A New Order of Things

Retirement Reforms: A Bipartisan Success Story

Caring About the State's Healthcare Plan

A Whole Lot of Alliteration: Spending Sustainability, Sufficiency and Soundness

Who Doesn't Want a Good Value?

The Budget Trifecta: Revenue Stability, Spending Discipline and Value Creation

First (and Lasting) Impressions: My First 100 Days

Consider inviting Ken to address these topics at your organization's next meeting or event.

Please contact us to schedule:

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